the above-captioned proceeding ("NPRM"), regarding the use of data obtained through the Automated Reporting Management Information System ("ARMIS") to evaluate rates for special access services. As set forth below, it would be problematic for the Commission to rely on ARMIS data, in particular the calculated jurisdictional, Part 69 element specific rates of return which are dependent on outdated cost allocation rules, to make pricing decisions about the Bell Operating Companies' ("BOCs") interstate special access services. This is especially true for the years starting in 2001. Even before the Commission issued its Separations Freeze ("Freeze") in 2001, precluding the Incumbent Local Exchange Carriers ("ILECs") from adjusting categorical and jurisdictional factors used to allocate costs across categories of services reported in ARMIS, the Commission recognized there were concerns that the Separations rules did not produce meaningful and reliable allocation results. The 2001 Freeze rendered the jurisdictional and Part 69 element cost allocations even more unreliable. As a result, rates of return calculated using ARMIS data, including special access rates of return, would be inherently flawed.

III. Summary

4. In a nutshell, the problem is that ARMIS cost data, which has been based on an outdated regulatory accounting regime at least since the late 1990s, became particularly unreliable when, in 2001, the Commission froze each carrier's categorical and jurisdictional factors as they existed in 2000. As a result, five years later, carriers continue to separate investment among various accounting categories and between intrastate and interstate jurisdictions by using the same percentage factors that they used in 2000, which were generally based on the carriers' cost-causation studies and analysis performed during *or before* 2000. By locking in the percentage of an incumbent ILEC's (including the BOCs') total investment and expense allocated to each service, there is a substantial likelihood that the freeze produces

ARMIS results that understate the costs an ILEC incurs to provide any service that has experienced significant growth in volumes.

5. The costs for interstate special access services are particularly susceptible to this understatement because demand has increased dramatically over the past several years with the explosive growth in data services. The result is a mismatch between costs which do not properly reflect current utilization and volumes and revenues which do. This mismatch, of course, will overstate the calculated rate of return.

IV. Overview of Separations Process

6. As the Commission has explained, ILECs are generally required to apportion their costs through a four-stage regulatory process:

> First, carriers record their costs, including investments and expenses, into various accounts in accordance with the Uniform System of Accounts ("USOA") prescribed by Part 32 of the Commission's rules. Second, carriers assign the costs in these accounts to regulated and nonregulated activities in accordance with Part 64 of the Commission's rules to ensure that the costs of non-regulated activities will not be recovered in regulated interstate service rates. Third, carriers separate the regulated costs between the intrastate and interstate jurisdictions in accordance with the Commission's Part 36 separations rules. Finally, carriers apportion the interstate regulated costs among the interexchange services and rate elements that form the cost basis for their interstate access tariffs. Carriers perform this apportionment in accordance with Part 69 of the Commission's rules. *See* Report and Order, *Jurisidictional Seperation and Referral to the Federal-State Joint Board,* 16 FCC Rcd 11382 ¶ 3 (2001) ("*Seperations Freeze Order*") (footnotes omitted).

7. The third stage identified above -- the Part 36 "jurisdictional separations" process -- consists of two steps:

> The first step in the separations process requires carriers to assign regulated costs to various categories of plant and expenses. In certain instances, costs are further disaggregated among service categories. In the second step, the costs in each category are apportioned between the intrastate and interstate jurisdictions. These jurisdictional apportionments of categorized costs are based upon either a relative use factor, a fixed allocator, or, when

> specifically allowed in the Part 36 rules, by direct assignment. For example, loop costs are allocated by a fixed allocator, which allocates 25% of the loop costs to the interstate jurisdiction and 75% of the costs to the intrastate jurisdiction. *See Separations Freeze Order* ¶ 4 (footnotes omitted).

8. Thus, the separations process requires BOCs to make both "categorical" and "jurisdictional" (*i.e.*, interstate or intrastate) cost allocations. To achieve "categorical" allocations, the regulated book costs derived under Part 32 (stage one above) for certain plant investment accounts and certain expense accounts are segregated into more detailed sub-categories generally based on cost-causative factors. After performing these categorical allocations, each sub-category is uniquely treated for jurisdictional allocation purposes, assigning the subdivided costs to interstate and intrastate functions.[1]

9. In the fourth stage identified above – the Part 69 apportionment process – BOCs assign the interstate portions of their subdivided regulated costs to the interexchange services and rate elements that form the cost basis for their interstate access tariffs. There are five primary rate element or categories for interstate services as reported in ARMIS: (1) special access; (2) common line; (3) traffic sensitive (which consists of switching, transport and information); (4) interexchange; and (5) billing and collection. As in the jurisdictional separations process, Part 69 assignments and allocations are generally based on cost-causation or allocations already established for other types of accounts.

10. Under both Part 36 and Part 69, many expense and reserve accounts are allocated among the jurisdictions and Part 69 service elements based on the allocation of the related plant investment. For example, total Central Office Equipment (COE) expense is allocated based on the composite allocation of total COE investment. Similarly, depreciation expense for a

[1] Categorical and jurisdictional allocations for some accounts may be performed in the same step.

particular plant account is typically allocated based on the allocation of the related plant investment account. For other expenses not specifically related to plant investment, the allocation is typically based on other cost-causative factors or based on general allocators developed from already established allocations of other accounts. Some of these other expense accounts include network and general support expenses, network operations expenses, marketing expenses, customer operations expense and corporate operations expense. For example, corporate operations expenses are allocated under Part 69 based on the "Big 3 Expenses," one of which is plant specific expenses. Because allocation of many plant specific expenses tracks the allocation of associated plant investment, a change in the allocation of investment would impact allocation of corporate operations expense. Similarly, network operations expenses are allocated under Part 69 based on the allocation of the combination of COE, Information Origination/Termination equipment ("IOT"), and Cable and Wire Facilities ("C&WF") investment. The allocation of general support facilities investment and general support expenses are likewise impacted by changes in the allocation of these other accounts. In sum, the allocation of plant investment has numerous and significant "downstream" impacts on other allocations, including allocations to special access.

11. As part of ARMIS, BOCs must annually report to the FCC the jurisdictional, service element cost results obtained under the procedures set forth above. These service element cost results are, obviously, heavily dependent on the Part 36/Part 69 cost allocations. Also as part of ARMIS, BOCs report their revenues that are assignable to each service element. While BOCs thus have to report both costs and revenues for their interstate service elements in ARMIS, the allocation and reporting of *costs* is much less straight-forward for the reasons stated in this declaration.

12. Under ARMIS, a rate of return for particular interstate access elements is not reported but can be calculated by dividing the reported net return by the reported average net investment. The results of such a calculation however, can be misleading for the reasons stated below.

V. The Separations Freeze

13. In 1997, the Commission initiated a proceeding seeking comment on, among other things, the extent to which legislative changes, technological changes, and market changes warranted comprehensive reform of the separations process. *See Separations Freeze Order* ¶ 5; Notice of Proposed Rulemaking, *Jurisdictional Separations Reform and Referral to the Federal-State Joint Board*, 12 FCC Rcd 22120 ¶ 4 (1997) ("*Separations NPRM*"). The Commission noted then that the network infrastructure was vastly different from the network and services used to define the cost categories appearing in the Commission's current Part 36 rules, and that the separations process codified in the current Part 36 rules was developed during a time when common carrier regulation presumed that interstate and intrastate telecommunications service must be provided through a regulated monopoly. *See Separations Freeze Order* ¶ 5; *Separations NPRM* ¶ 9.

14. In May 2001, the Commission issued its *Separations Freeze Order*, in which the Commission acknowledged that the separations rules were "outdated regulatory mechanisms that are out of step with today's rapidly-evolving telecommunications marketplace." *See Separations Freeze Order* ¶ 1. The Commission recounted that the Federal State Joint Board on Separations had urged adoption of an interim "freeze" of the Part 36 category relationships and jurisdictional cost allocation factors, pending comprehensive reform of the Part 36 separations rules. The Commission agreed that these measures would simplify and bring regulatory certainty to the

separations process in a time of rapid market and technology changes until such reform is completed.

15. The interim freeze which began on July 1, 2001 was scheduled to be in effect for five years or until the Commission completed comprehensive separations reform, whichever came first. Before the Commission issued its 2001 Freeze, the BOCs developed the categorical and jurisdictional allocators for many investment accounts by periodically conducting extensive studies and analyses on how that investment was actually being used.[2] The 2001 Freeze however, ordered BOCs to continue to use the allocators in effect in 2000 for the next five years (or until the separations rules were revised), thereby obviating the need for additional studies during this time. These frozen categorical and allocation factors are still in effect today.

VI. Because of the Freeze, ARMIS data is even less relevant to reports of costs and rates of return for the BOCs' special access services.

16. As the FCC has shifted away from cost-based regulation of the BOCs' interstate access charges, the usefulness and importance of the Part 36/Part 69 Separations process has declined considerably. Because of this and the changing natures of technology and the telecommunications marketplace, SBC supported the Freeze as a transitional step until the FCC eliminates the Separations process altogether.

17. That said, the Freeze heightened concerns about the accuracy and reliability of the Part 36 cost allocations and the resulting element specific, jurisdictional rates of return, especially in connection with making pricing decisions. For reasons stated by the FCC in the *Separations NPRM* and the *Separations Freeze Order*, among others, reliance on the Part 36/Part

[2] Allocations for certain expense accounts were also based on study and analysis of the functions causing the expense.

69 allocation process generated its own concerns notwithstanding the Freeze. The Freeze, however, further undermined the accuracy and reliability of the allocation process, by precluding the BOCs from adjusting their allocation factors to account for changes in the way costs are incurred. Because the Freeze "locked in" then-existing categorical and jurisdictional factors, shifts or changes in usage patterns since 2000 are not properly reflected in cost allocation results reported under ARMIS. Meanwhile, the BOCs' assignment of *revenues* as reported in ARMIS generally reflects current activity associated with the various jurisdiction and access elements, because the revenues are for the most part already tracked and booked in this manner. The likely result is a continually worsening mismatch between costs and revenues on a jurisdictional, access element basis, which in turn further distorts the calculated ARMIS-based rates of return for these elements.

18. The potential for revenue-cost mismatch is particularly apparent among the special access element and the other Part 69 elements. Over the past five years, the number of special access lines has grown significantly while the number of switched access lines has significantly decreased. As shown in Attachment 1, the number of SBC's special access lines grew 127% (cumulatively) between 1999 and 2004. The BOCs combined saw their special access lines increase nearly 150% over the same period. Meanwhile, the number of SBC's switched access lines decreased 23% (cumulatively), and the BOCs combined saw their switched access lines decrease 21%.[3]

19. As one would expect, the BOCs' revenues for these services have followed similar trends. By 2004, the BOCs' combined interstate special access revenues had increased approximately 100% since 1999, while the combined interstate common line and traffic sensitive

[3] Source of data is ARMIS 43-08, Table III, Access Lines in Service By Customer.

revenues had decreased nearly 24% over this same time period. When a switched access line is lost, the interstate end user common line revenue as well as any interstate switched access revenue related to that line is likewise lost.

20. Given the rapid increase in special access lines, accompanied by the significant decline in switched access, it stands to reason that recent investment in the regulated network would have been more proportionately focused on the Part 36 sub-categories that support special access and less proportionately focused on the sub-categories that support switched and common line services. Crucially, changes in investment patterns like this would *not* be properly reflected in the current Part 36 or Part 69 allocation results because of the Freeze. And, to the extent allocation of plant investment has been skewed away from special access, so too have "downstream" allocations of plant specific expenses, depreciation and amortization expenses, and other indirectly allocated accounts. Allocations of other costs, such as marketing and customer service expenses, also may have been impacted.

VII. An Analysis of ARMIS Reported Data Evidences the Mismatch Between Special Access Costs and Revenues

21. ARMIS reporting trends from 1995 through 2004 support a conclusion that the 2001 Freeze resulted in (or worsened) a mismatch between special access revenues and costs resulting from the Part 36/Part 69 allocation process. Although individual state results vary, a high level analysis using aggregate BOC and/or composite SBC data to show trends and relationships evidences this mismatch. As set forth below, although, *before* 2001, increases in ARMIS-reported interstate special access costs as percentages of total costs subject to separations tended to keep pace with increases in ARMIS-reported interstate special access revenues as percentages of total revenues subject to separations, *after* 2001 this relationship was severed. Specifically, the revenue-cost mismatch exacerbated by the Freeze is apparent through (1) reported plant

investment compared to special access revenues; and (2) reported support expenses compared to special access revenues.[4]

A. ARMIS reporting of plant investment in facilities related to special access

22. The majority of plant investment ultimately allocated to interstate special access is COE Transmission Equipment and C&WF. In 2004, for all BOCs combined, these two accounts made up 89% of the total plant investment ultimately apportioned to interstate special access. Attachment 2 analyzes for the aggregate of all BOCs: (1) the percentage of COE Transmission subject to separations that is ultimately allocated to interstate special access (2) the percentage of C&WF subject to separations that is ultimately allocated to interstate special access; (3) the percentage of total Telecommunications Plant in Service subject to separations that is ultimately allocated to interstate special access; and (4) interstate special access revenues as a percentage of total revenues subject to separations.

23. Attachment 2 demonstrates that, from 1995 through 2000, the percentages of COE Transmission, C&WF, and total Plant in Service investments ultimately allocated to the interstate special access element grew consistently with the growth in interstate special access revenues as a percentage of total revenues subject to separations. Starting in 2001, however, interstate special access revenues as a percentage of total revenues subject to separations continued to grow (increasing from 9.5% in 2000 to 16% in 2004), but the percentages of investment

[4] ARMIS data used in the analysis included in this declaration is based on currently filed ARMIS data. SBC is aware of and is currently analyzing certain data items that will and/or may require revisions to its currently filed ARMIS data. However, SBC estimates that the magnitude of these items currently under review will not cause significant changes in the high level data analysis provided in this declaration. Once SBC completes its review, the analysis in this declaration will be updated to reflect any significant amendments to filed ARMIS results.

allocated to interstate special access for each of the plant accounts *flattened out* during this same time period.

24. This plant investment data strongly suggests that, by locking in Part 36 categorical and jurisdictional allocators, the Freeze prevented the natural and proportionate growth of cost allocations to elements (such as interstate special access) that were experiencing significant growth in volumes and revenues. Historically, right up until the Freeze, the growth of the percentage allocation of total plant investment to special access followed a similar pattern to the growth of interstate special access revenues as a percentage of total revenues. The fact that this trend changed right after the Freeze provides strong evidence that the change was an artificial byproduct of the Freeze. The Freeze had the effect of keeping the percentage allocation of special access investment flat even as the percentage of special access revenues continued to grow. It follows that any calculation of rates of return for special access based on these frozen investment allocations would be overstated.

B. ARMIS reporting of support expenses apportioned to special access

25. As discussed earlier, an improper allocation of plant investment would also result in an improper allocation of the related plant specific expenses because the allocation of those expenses is based on the allocation of the related plant. In addition, other non-plant related expenses also appear to be impacted by the Freeze in the same way. Just as the percentage of special access-related investment ceased to keep pace with special access revenues as a percentage of total revenues subject to separations, so too did the reported percentage of various *support* costs related to special access start to lag in that year. These costs include general support facilities investment, network and general support expenses, network operations expenses, marketing expenses, other customer operations expenses and corporate operations

expense. The allocation of most of these support costs is either directly or indirectly dependent upon allocators developed for plant investment.[5]

26. As demonstrated by Attachments 3 and 3A (again using aggregate BOC ARMIS data), the percentages of the support-type costs identified in the preceding paragraph that were allocated to special access in 1995 ranged from 2.8% to 4.4%. The weighted average percentage of the composite support expenses allocated to special access in 1995 was 3.6%. Also in 1995, special access revenues constituted 3.5% of total revenues subject to separations. Thus, in 1995, the weighted average percentage of support-type costs allocated to special access was closely proximate to the percentage of revenues allocated to special access.

27. As Attachment 3 further demonstrates, by 2004 the percentage of support-type costs allocated to special access had increased to a range of 6% to 10%, and the average weighted percentage of the composite support expenses had approximately doubled to 7.7%; however, the percentage of total revenues made up of special access had more than *quadrupled* to 16%. Thus, from 1995 to 2004, the percentage of total revenues made up of special access grew at more than twice the rate of the average weighted percentage of support-type costs allocated to special access.

28. Moreover, Attachment 3A shows that, after the Freeze, as interstate special access as a percent of total revenues continued to grow, the weighted average percentage allocation of special access support-type costs *started to flatten out*. Since the Freeze, there has been minimal, if any growth in the allocation of these costs despite the continued growth in the percent special

[5] The Part 36 allocation of marketing expense is based on an analysis of billed revenues (subject to the Freeze), but the Part 69 allocation is based on plant investment. The allocation of other customer operations expenses (also frozen) was typically based on a study or analysis of customer contacts, and, therefore, could reasonably be expected to vary as the number of customers varied.

access revenues. Again, the fact that the growth in the percentage cost allocation and percentage revenue for special access started to diverge in 2001, the year in which the Freeze took effect, is strong evidence that the reported lag in the cost allocation is a byproduct of the freeze. These trends further illustrate the special access cost-revenue mismatch exacerbated by the Freeze.

VIII. Although the Freeze was on Part 36, the Categorical Allocators Directly Impact Part 69 Allocations to Special Access

29. As discussed previously, COE Transmission and C&WF make up a large majority of the investment allocated to interstate Special Access under Parts 36 and 69. Under Part 36, these two investment accounts must be segregated into sub-categories before jurisdictional and Part 69 apportionments occur.

30. Under Part 36, COE Transmission plant is referred to as Circuit Equipment or COE Category 4. Part 36 divides COE Category 4 into a number of subcategories based on the characteristics and functions of the circuit equipment.[6] These subcategories are reported in ARMIS 43-04 as set forth in Attachment 4. (Part 36 also sets forth several similar sub-categories for C&WF, with some sub-categories more relevant to special access than others.) The apportionment into these sub-categories is subject to the Freeze, meaning that each sub-category should continue to represent the same percent of the total COE Category 4 as it did in year 2000.

31. Attachment 4 demonstrates how both SBC and the BOCs (in the aggregate) assign total COE Category 4 among the sub-categories. This allocation of COE Category 4 into sub-categories is important because for Part 69 purposes, with only minor exceptions, the interstate portion of the dollars in each of these individual sub-categories is assigned directly and completely to unique rate elements under Part 69. Generally speaking, all of the "wideband" and

[6] See 47 C.F.R. § 36.126(b).

"private line" sub-categories relate to special access. Accordingly, SBC assigns the interstate portions of "Category 4.11 -- Wideband" (ARMIS row 1220), as well as the private line sub-categories (rows 1230, 1274 and 1336) completely to the special access element. Conversely, SBC assigns the interstate portions of the "message" and "joint use" sub-categories completely to the other Part 69 elements, primarily the common line or traffic sensitive elements. (Other BOCs appear to generally follow the same methods, although some utilize other wideband and private line sub-categories in addition to those mentioned above).

32. Attachment 4 shows that as a result of the separations processes discussed above, approximately 24% of all COE Category 4 investment is allocated to Wideband sub-categories for both SBC (in the aggregate) and the total of all BOCs combined. In addition, for SBC approximately 11% of COE Category 4 is allocated to private line sub-categories for a total of approximately 35% for Wideband and Private Line combined. For the combined BOCs, those respective percentages are approximately 12% and 36%. (Based on the frozen jurisdictional allocation of these sub-categories, approximately 20% of the total COE Category 4 investment subject to separations is allocated to interstate special access for SBC and approximately 22% for the combined BOCs.)

33. Further analysis of just the COE Category 4 investment allocation helps show the potential extent of distortion created by the Freeze. Specifically, the allocation of the *growth* of COE Category 4 investment since 2000, based on the Freeze, is not consistent with the overall volume trends (discussed earlier) related to special access.

34. Attachment 5 demonstrates, based on data from ARMIS report 43-04, that SBC's COE Category 4 gross plant investment *grew* $6.5 billion from 2000 to 2004. As a result of the Freeze, SBC apportioned only $1.7 billion of this growth to Category 4.11 -- Wideband, which,

as noted, has the interstate portion assigned in its entirety to special access. Increasing the amount of this growth apportioned to Category 4.11 by just 10% -- what appears to be an extremely conservative increase in light of the rapid growth in special access lines over this time -- would yield an additional $651 million in investment apportioned to Category 4.11. Assuming no change in the jurisdictional allocation of Category 4.11, the 10% category reclassification would result in approximately $455M of additional interstate special access investment.[7] Moreover, if one assumed that as much as 50% of the *growth* in COE Category 4 since 2000 should have been allocated to Category 4.11 -- a more aggressive but not implausible assumption in light of pervasive special access demand growth -- the latter sub-category investment would increase by nearly $1.6 billion (50% of $6.5 billion minus the frozen growth of $1.7 billion). Again, assuming no change in the jurisdictional allocation of Category 4.11, use of a 50% growth allocator would result in more than $1.1 billion in additional interstate special access investment for SBC.

VIII. Forecast of COE Category 4 Allocations Using Historical Trends

35. Because the Part 36 sub-categories are not typical of how capital spending is tracked, it is difficult to determine with specificity how, but for the *Freeze*, allocation of COE Category 4 would have changed since 2000 (and, based on concerns about the allocations process even before the Freeze, such a revised allocation may not be reliable in any event). However, as discussed above prior to Freeze: the BOCs' allocation of COE Category 4 investment to the interstate special access element trended fairly consistently with BOCs' interstate special access

[7] The interstate factor is derived from ARMIS 43-04, row 1220, column d divided by column b.

revenues as a percentage of their total revenues subject to separations. It appears reasonable to assume that, but for the Freeze, this trend would have continued.

36. One methodology for estimating the amount of COE Category 4 investment that SBC would have allocated to the interstate special access element, but for the Freeze, is to apply Microsoft Excel's linear regression forecasting function to the trend obtained from 1995 to 2000 ARMIS data. Although individual states vary, Attachment 6 shows the consolidated SBC results of that forecasting estimate. The thick line at the top of the graph represents the percentage of COE Category 4 investment that has been allocated to interstate special access, including the impacts of the Freeze. The dashed line on the charts represents the forecasted estimate. The bottom line represents the interstate special access revenues as a percentage of total subject to separations revenues. As Attachment 6 demonstrates, the allocation forecast -- which increases in roughly parallel fashion to the actual revenue trend -- produces a far higher allocation of COE Category 4 to interstate special access. Using this forecasted estimate rather than the frozen results would result in more than $1.5 billion of additional COE Category 4 plant investment allocated to interstate special access.

37. A shift in plant investment like this would also drive increases in the allocation to interstate special access for many other accounts due to the "downstream" allocation effects discussed previously.

IX. ARMIS reports show, for 1999 to 2004, declining overall rates of return but divergent returns for interstate access services.

38. Finally, a high level review of rates of return calculated using ARMIS data undermines the notion that rates of return for different services can be meaningfully analyzed in isolation from one another.

39. Attachments 7 and 7A set forth the aggregate BOC rates of return for interstate, intrastate and combined interstate/intrastate services, for the period 1999 to 2004 calculated using ARMIS data.[8] These data demonstrate that (1) the rate of return for interstate services for all BOCs combined increased just slightly from over 18% in 1999 to just under 20% in 2004; (2) the rate of return for intrastate services for all BOCs combined trended down from approximately 15% in 1999 to approximately 9% in 2004; (3) the BOC combined interstate/intrastate rate of return trended down from approximately 16% in 1999 to approximately 13% in 2004. Because the combined return data reflects the costs and revenues of the firms prior to the problematic allocations mandated by the separations process, they provide a more reliable depiction of the firms' results.

40. Notwithstanding these fairly consistent and moderate results, however, the data *also* demonstrates that BOC rates of return for the interstate access elements have sharply diverged: although from 1999 to 2004, the combined BOC rate of return for interstate special access service has increased, the rates of return for other interstate access elements have significantly *decreased.* Specifically, the data shows that the rate of return for all BOCs' interstate common line services fell by more than half between 1999 and 2004. (SBC's rate of return for this element fell by two thirds). Even more dramatically, the combined BOC rate of return for interstate (total) traffic sensitive services fell from 27% in 1999 to 2% in 2004. (SBC has had a *negative* rate of return for total traffic sensitive services from 2002 to 2004).

41. These rate-of-return data, like the data set forth above for investment and expense allocations, are consistent with the proposition that the Freeze exacerbated the cost-revenue

[8] ARMIS report 43-01 includes both interstate and intrastate allocation results. Although an intrastate rate of return is not displayed on the report, for this analysis it is calculated by applying the same methodology that is used in ARMIS for calculating the reported interstate rate of return.

mismatch. The data also suggests that, *regardless* of the accuracy and reliability of the special access cost data reported under ARMIS, it would be unreasonable to consider only the special access interstate element of BOCs' services in isolation of the BOCs' other interstate elements.

IX. Conclusion

42. In sum, the Separations Freeze significantly exacerbated already existing concerns about the reliability and meaningfulness of the cost allocations resulting from the Separations process and reported in ARMIS. Since the Freeze, SBC and the BOCs special access lines increased significantly while switched access lines are decreasing, almost certainly creating an upsurge in investment used for special access. The allocation results obtained under Parts 36 and 69 very likely do not accurately reflect this upsurge, because the percentages used to assign costs jurisdictionally and categorically were frozen as a result of the FCC's *Seperations Freeze Order.* These frozen percentages affect not only the accounts directly apportioned by them, but also numerous other accounts whose allocation is contingent either directly or indirectly on the allocation of those direct accounts. The upward trend of the percentages of plant investment and expenses allocated to special access *before* the Freeze further support the strong likelihood that post-2001 allocations reported under ARMIS are distorted. These complications with the cost allocations, the concerns with Separations that pre-existed the Freeze and the divergent ARMIS based results of the special access element compared to the other Part 69 element results, severely undermine the reliability of this data, especially when deciding whether and how to regulate pricing of interstate special access services.

I declare under penalty of perjury that the foregoing is true and correct to the best of my knowledge.

Executed on June 13, 2005.

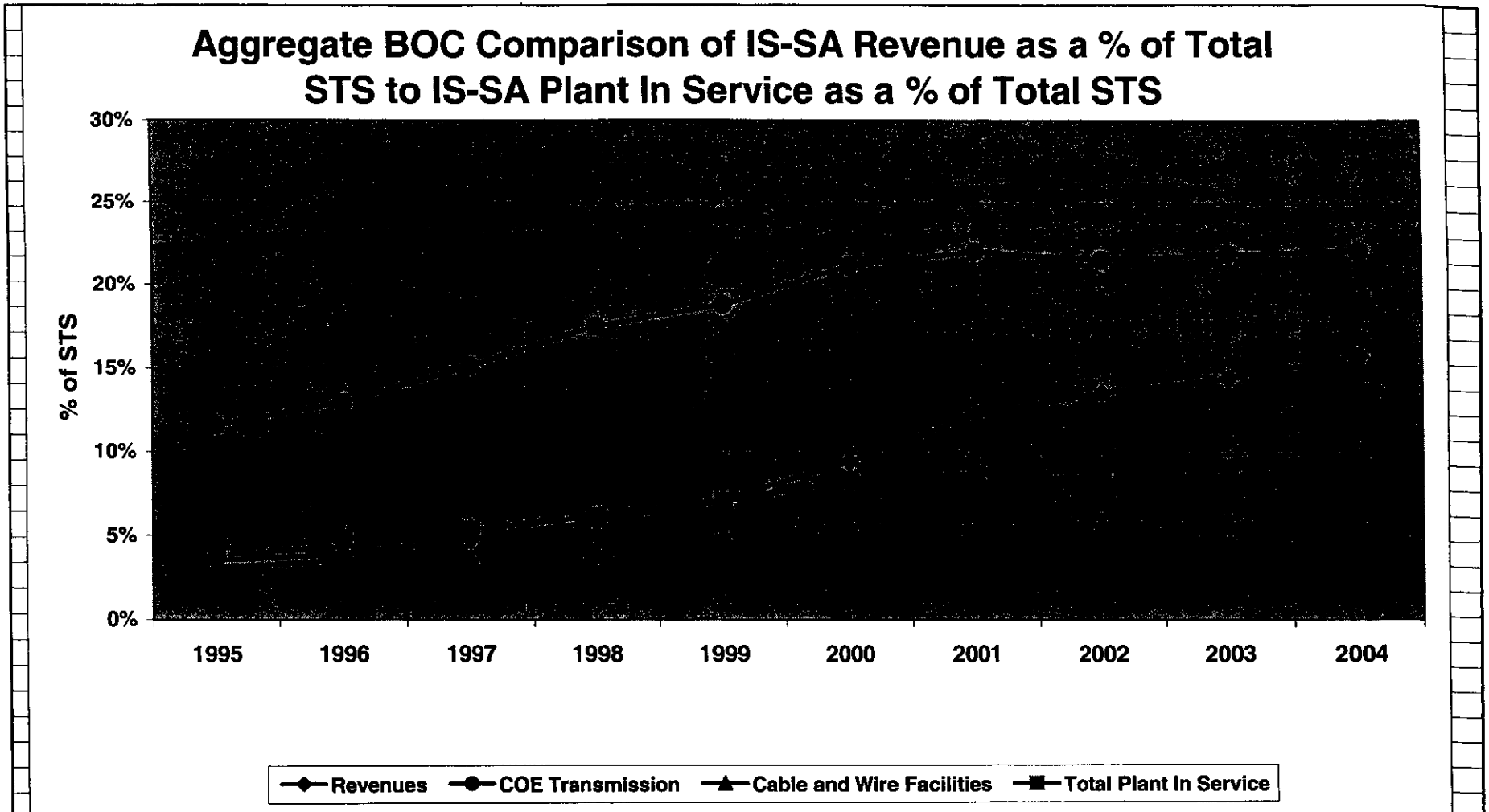
Dave Toti

David Toti

Attachment 1

Access Line and Revenue Trends (in millions)							
Special Access Lines	**1999**	**2000**	**2001**	**2002**	**2003**	**2004**	
SBC	21.9	27.1	31.6	41.1	45.5	49.6	
Total BOC	48.8	65.6	79.6	94.3	108.8	121.8	
							Cumulative
YOY growth %		**2000**	**2001**	**2002**	**2003**	**2004**	**% Growth**
SBC		23.8%	16.6%	30.1%	10.8%	9.0%	126.9%
Total BOC		34.4%	21.3%	18.5%	15.4%	12.0%	149.5%
Switched Access Lines (M)	**1999**	**2000**	**2001**	**2002**	**2003**	**2004**	
SBC	58.4	58.0	53.9	51.1	47.0	44.8	
Total BOC	164.6	163.8	156.2	147.1	137.3	130.5	
							Cumulative
YOY growth %		**2000**	**2001**	**2002**	**2003**	**2004**	**% Growth**
SBC		-0.7%	-7.1%	-5.2%	-8.0%	-4.7%	-23.3%
Total BOC		-0.5%	-4.6%	-5.8%	-6.7%	-5.0%	-20.7%
Special Access Revenues	**1999**	**2000**	**2001**	**2002**	**2003**	**2004**	
SBC	2,481	3,406	4,375	4,348	4,429	4,506	
Total BOC	7,141	9,592	12,414	12,967	13,440	14,274	
							Cumulative
YOY growth %		**2000**	**2001**	**2002**	**2003**	**2004**	**% Growth**
SBC		37.3%	28.5%	-0.6%	1.9%	1.7%	81.7%
Total BOC		34.3%	29.4%	4.5%	3.6%	6.2%	99.9%
Interstate Common Line and Traffic Sensitive Revenues							
SBC	**1999**	**2000**	**2001**	**2002**	**2003**	**2004**	
Interstate Common Line	3,706	3,712	3,821	3,297	3,238	2,995	
Interstate Traffic Sensitive	1,776	1,538	1,173	1,072	1,021	1,045	
Combined	5,482	5,250	4,994	4,370	4,259	4,040	
							Cumulative
YOY growth %		**2000**	**2001**	**2002**	**2003**	**2004**	**% Growth**
SBC		-4.2%	-4.9%	-12.5%	-2.5%	-5.1%	-26.3%
Combined BOC	**1999**	**2000**	**2001**	**2002**	**2003**	**2004**	
Interstate Common Line	12,937	12,822	12,789	11,576	11,430	10,827	
Interstate Traffic Sensitive	5,414	4,783	3,721	3,357	3,319	3,204	
Combined	18,351	17,606	16,511	14,933	14,749	14,031	
							Cumulative
YOY growth %		**2000**	**2001**	**2002**	**2003**	**2004**	**% Growth**
SBC		-4.1%	-6.2%	-9.6%	-1.2%	-4.9%	-23.5%
Source: ARMIS 43-08, Table III for access lines. ARMIS 43-01 for Revenues.							

Attachment 2



Interstate Special Access as a % of Total Subject to Separations										
	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
Revenues	3.5%	3.9%	4.8%	5.9%	7.2%	9.5%	12.4%	13.7%	14.6%	16.0%
COE Transmission	11.6%	13.0%	15.2%	17.6%	18.9%	21.3%	22.2%	21.7%	22.1%	22.3%
Cable and Wire Facilities	3.1%	3.5%	3.6%	3.9%	5.0%	5.7%	5.5%	5.8%	5.8%	5.8%
Total Plant In Service	4.2%	4.8%	5.4%	6.2%	7.1%	8.4%	8.8%	9.0%	9.2%	9.4%
Source of underlying data is ARMIS 43-01 report, rows 1090, 1650, 1660 and 1690, columns (s) and (f).										

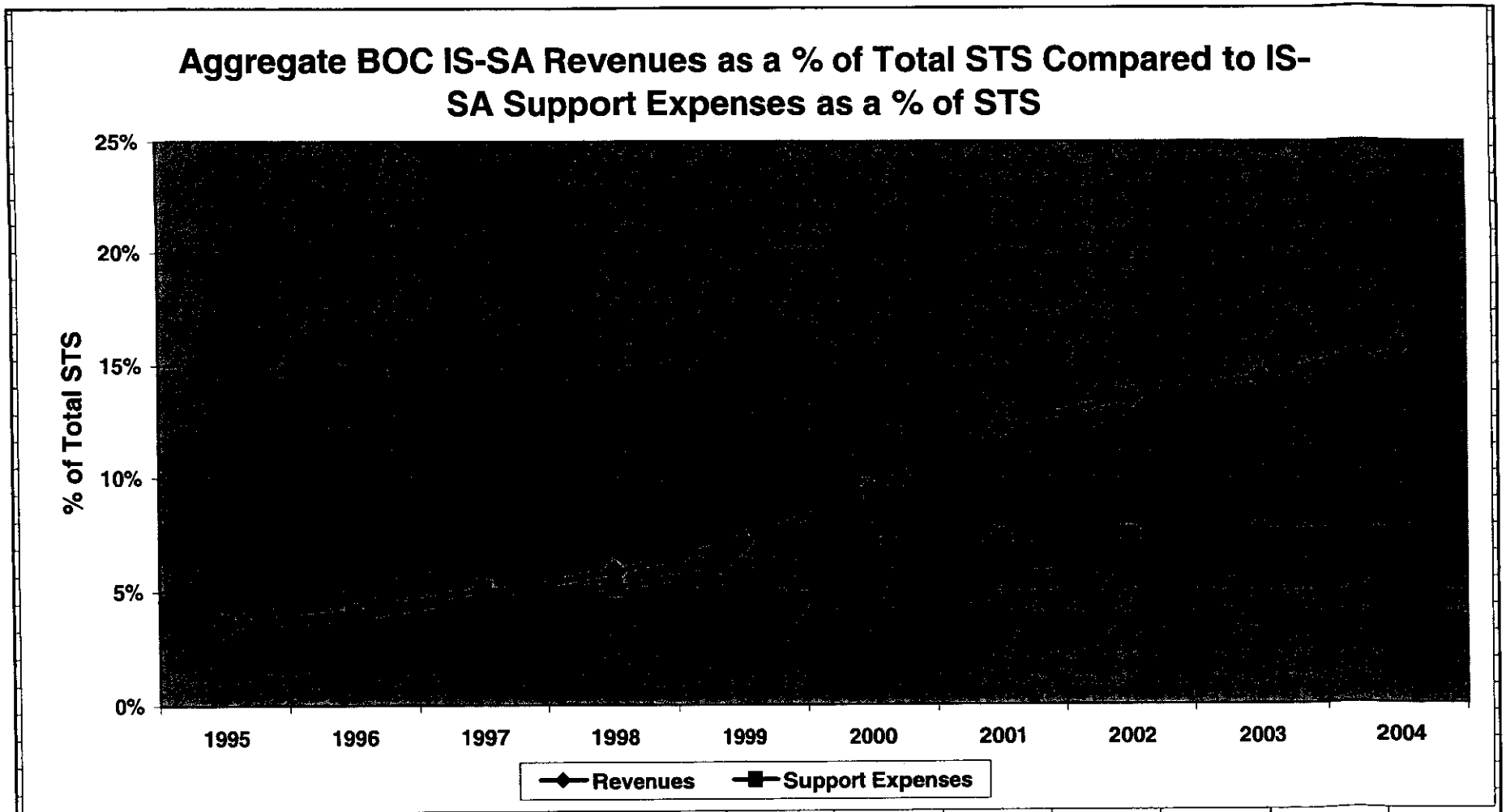
Attachment 3

Aggregate BOC Interstate Special Access Revenue as a % of Subject to Separations Revenue
Compared to Interstate Special Access Support Costs as a % of Subject to Separations Support Costs

	Using 1995 ARMIS Data ($000's)			Using 2004 ARMIS Data ($000's)		
Total BOCs	**STS**	**IS - SA**	**IS-SA as a % of STS**	**STS**	**IS - SA**	**IS-SA as a % of STS**
Revenues	84,526,966	2,923,970	3.5%	89,077,280	14,274,143	16.0%
General Support Facilities	37,523,087	1,472,110	3.9%	39,558,056	3,333,297	8.4%
Network and General Support Exp	4,921,591	183,094	3.7%	4,044,508	334,173	8.3%
Network Operations Expense	6,055,043	264,569	4.4%	5,624,574	567,375	10.1%
Marketing Expense	3,354,556	133,741	4.0%	3,520,121	314,171	8.9%
Other Customer Operations Exp	6,028,240	167,920	2.8%	5,792,034	345,390	6.0%
Corporate Operations Expense	9,838,693	329,838	3.4%	11,041,733	742,541	6.7%
Total selected support expenses	30,198,123	1,079,162	3.6%	30,022,970	2,303,650	7.7%

Source: ARMIS 43-04 Report. Total selected support expenses equals sum of Network and General Support Expense, Network Operations Expense, Marketing expense, Other Customer Operations expense and Corporate Operations expense.

Attachment 3A



	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
Revenues	3.5%	3.9%	4.8%	5.9%	7.2%	9.5%	12.4%	13.7%	14.6%	16.0%
Support Expenses	3.6%	4.1%	5.1%	5.2%	6.1%	7.2%	7.4%	7.5%	7.7%	7.7%

Source of underlying data is ARMIS 43-04.

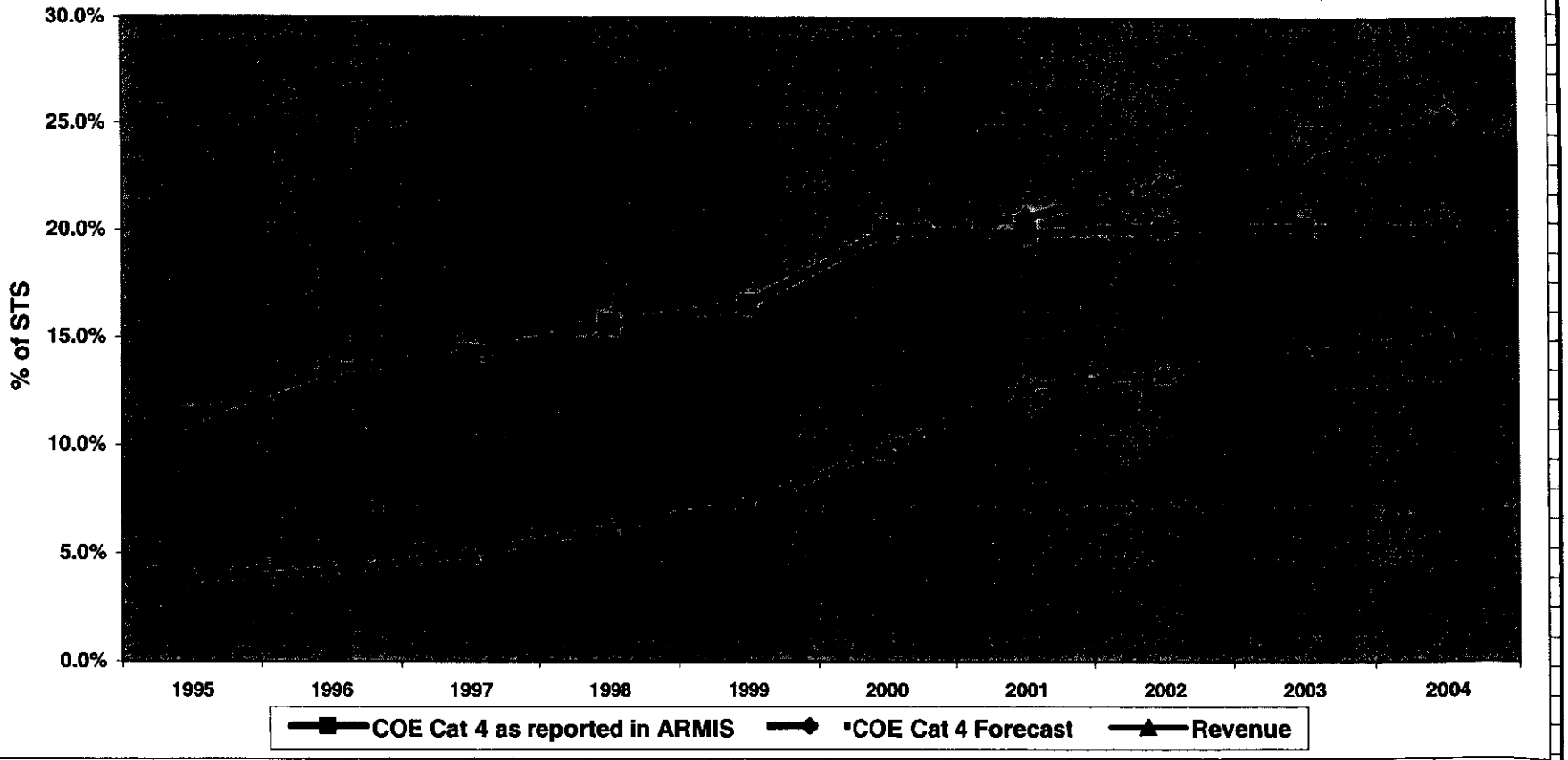
Attachment 4

2004 ARMIS Allocation of COE Category 4 Plant By Sub-Category ($000's)				
ARMIS				
Row	**SBC Communications**		**Subj to Sep**	**% of Total**
1220	COE Cat 4.11 Wideband Exchange Line Circuit Equipment	*	7,499,024	24.5%
1230	COE Cat 4.12 Basic Exchange Trunk Circuit Equipment - Private Line		1,861,304	6.1%
1231	COE Cat 4.12 Basic Exchange Trunk Circuit Equipment - Message		-	0.0%
1232	COE Cat 4.12 Basic Exchange Trunk Circuit Equipment - Joint Use		3,754,069	12.2%
1240	COE Cat 4.12 Special Exchange Trunk Circuit Equipment - Private Line		-	0.0%
1250	COE Cat 4.12 Wideband Exchange Trunk Circuit Equipment - Private Line	*	-	0.0%
1274	COE Cat 4.13 Basic Exchange Line Circuit Equipment - Private Line		511,578	1.7%
1275	COE Cat 4.13 Basic Exchange Line Circuit Equipment - Joint Use		11,971,460	39.0%
1280	COE Cat 4.13 Special Exchange Trunk Circuit Equipment - Private Line		-	0.0%
1320	COE Cat 4.22 Wideband Interexchange Circuit Equipment - Private Line	*	-	0.0%
1336	COE Cat 4.23 Basic Interexchange Circuit Equipment - Private Line		956,304	3.1%
1338	COE Cat 4.23 Basic Interexchange Circuit Equipment - Joint Use		3,667,051	12.0%
1350	COE Cat 4.23 Special Interexchange Circuit Equipment - Private Line		-	0.0%
1392	COE Cat 4.3 Host/Remote Message Circuit Equipment - Joint Use		448,609	1.5%
1400	Total COE Cat 4 Investment		30,669,399	100.0%
	Total of Wideband sub-categories *		7,499,024	24.5%
ARMIS				
Row	**Total of All BOCs**		**Subj to Sep**	**% of Total**
1220	COE Cat 4.11 Wideband Exchange Line Circuit Equipment	*	15,945,564	17.2%
1230	COE Cat 4.12 Basic Exchange Trunk Circuit Equipment - Private Line		7,466,327	8.0%
1231	COE Cat 4.12 Basic Exchange Trunk Circuit Equipment - Message		2,188,439	2.4%
1232	COE Cat 4.12 Basic Exchange Trunk Circuit Equipment - Joint Use		5,849,616	6.3%
1240	COE Cat 4.12 Special Exchange Trunk Circuit Equipment - Private Line		7,578	0.0%
1250	COE Cat 4.12 Wideband Exchange Trunk Circuit Equipment - Private Line	*	5,435,609	5.9%
1274	COE Cat 4.13 Basic Exchange Line Circuit Equipment - Private Line		1,554,866	1.7%
1275	COE Cat 4.13 Basic Exchange Line Circuit Equipment - Joint Use		40,909,095	44.1%
1280	COE Cat 4.13 Special Exchange Trunk Circuit Equipment - Private Line		81,453	0.1%
1320	COE Cat 4.22 Wideband Interexchange Circuit Equipment - Private Line	*	574,689	0.6%
1336	COE Cat 4.23 Basic Interexchange Circuit Equipment - Private Line		2,467,185	2.7%
1338	COE Cat 4.23 Basic Interexchange Circuit Equipment - Joint Use		9,389,174	10.1%
1350	COE Cat 4.23 Special Interexchange Circuit Equipment - Private Line		32,346	0.0%
1392	COE Cat 4.3 Host/Remote Message Circuit Equipment - Joint Use		903,276	1.0%
1400	Total COE Cat 4 Investment		92,805,217	100.0%
	Total of Wideband sub-categories •		21,955,862	23.7%
Source of all data is ARMIS 43-04 report using the Subject to Separations column (Column b).				

Attachment 5

Growth in SBC's ARMIS COE Category 4 ($000's)			
	SUBJECT TO SEPARATIONS		
COE Category 4 Investment	**2004**	**2000**	**Growth**
COE Cat 4.11 Wideband	7,499,024	5,836,773	1,662,251
All Other COE Cat 4 Investment	23,170,375	18,323,414	4,846,961
Total COE Cat 4 Investment	30,669,399	24,160,187	6,509,212
Total Growth			6,509,212
Assumed Increase in Apportionment to Wideband			10.0%
Additional Wideband investment			*650,921*
Current interstate allocation			*69.83%*
Additional Interstate Special Access Investment			*454,538*
Total Growth			6,509,212
Assumed total Apportionment to Wideband			50.0%
Adjusted growth in Wideband			*3,254,606*
Growth in Wideband based on Frozen Factors (above)			*1,662,251*
Additional Wideband investment			*1,592,355*
Current interstate allocation			*69.83%*
Additional Interstate Special Access Investment			*1,111,941*
Source is ARMIS 43-04, column b.			

Attachment 6



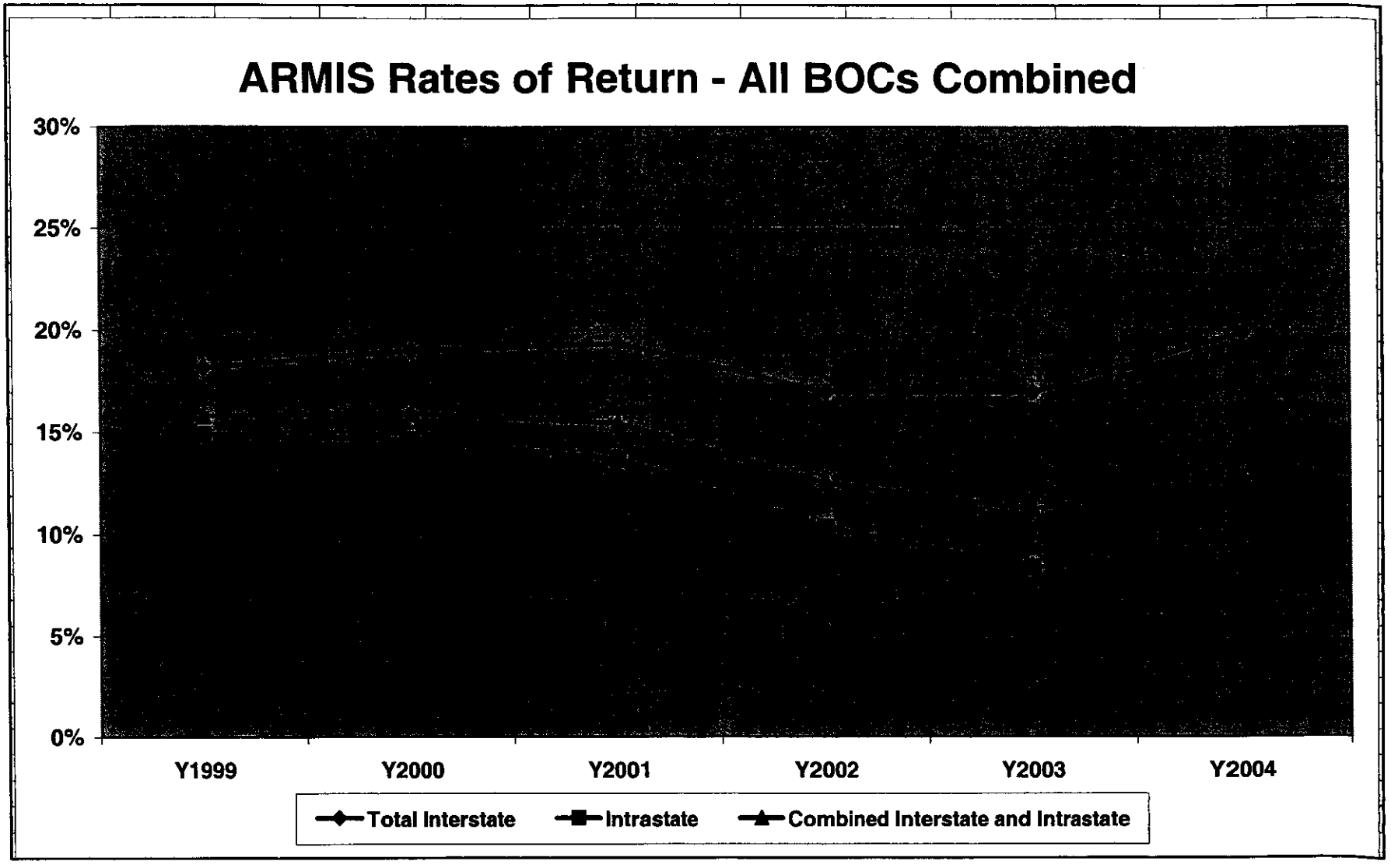
	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
COE Cat 4 as reported in ARMIS	11.2%	13.5%	14.2%	15.7%	16.6%	20.1%	20.0%	20.3%	20.3%	20.2%
COE Cat 4 Forecast	11.2%	13.5%	14.2%	15.7%	16.6%	20.1%	20.7%	22.3%	23.9%	25.4%
Revenue	3.8%	4.2%	5.0%	6.2%	7.4%	9.9%	12.8%	13.4%	14.4%	15.2%

Source of underlying data is ARMIS 43-01 report, rows 1090 and 1650, columns (s) and (f).

Attachment 7

Rates of Return Calculated Using ARMIS Data						
Total BOC						
	Y1999	**Y2000**	**Y2001**	**Y2002**	**Y2003**	**Y2004**
Total Interstate	18.2%	19.0%	19.4%	17.0%	17.0%	19.9%
Intrastate	14.9%	14.6%	13.7%	10.4%	8.4%	9.0%
Combined Interstate and Intrastate	15.8%	16.0%	15.5%	12.5%	11.2%	12.8%
Interstate Common Line	17.0%	15.7%	14.7%	10.3%	9.7%	8.3%
Interstate Traffic Sensitive	27.4%	21.2%	7.7%	4.6%	2.8%	2.5%
Interstate Special Access	22.6%	27.7%	38.3%	39.8%	43.5%	53.7%
SBC						
Total Interstate	18.9%	20.3%	22.8%	18.1%	19.8%	22.2%
Intrastate	15.3%	17.2%	16.3%	11.4%	9.9%	12.5%
Combined Interstate and Intrastate	16.2%	18.1%	18.2%	13.5%	13.0%	15.8%
Interstate Common Line	15.1%	13.8%	15.1%	6.6%	7.6%	5.0%
Interstate Traffic Sensitive	19.1%	13.7%	1.4%	-0.9%	-4.9%	-4.2%
Interstate Special Access	39.5%	41.7%	61.4%	53.1%	63.2%	76.2%
Source of underlying data is ARMIS 43-01						

Attachment 7A



D

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of	)	
Special Access Rates for Price Cap Local Exchange Carriers	)	WC Docket No. 05-25
AT&T Corp. Petition for Rulemaking to Reform Regulation of Incumbent Local Exchange Carrier Rates for Interstate Special Access Services	)	RM-10593

DECLARATION OF JOHN C. KLICK AND MICHAEL R. BARANOWSKI ON BEHALF OF SBC COMMUNICATIONS INC.

I. INTRODUCTION AND STATEMENT OF QUALIFICATIONS

1. We are John C. Klick and Michael R. Baranowski. We are Senior Managing Directors of FTI Consulting, Inc., with offices located at 1201 I Street, NW, Suite 400, Washington, DC 20005. Since the late 1980s we have been involved in analyzing issues related to productivity for a variety of network industries, including the telecommunications industry. Copies of our curriculum vitae are attached as Exhibits 1 and 2, respectively, to this Declaration.

2. We have been asked by SBC Communications Inc. ("SBC") to provide our assessment of the Commission's proposals in paragraphs 31 through 40 of the *Special Access NPRM* ("*Notice*" or "*NPRM*") concerning the possible reimposition of a productivity and/or growth factor as part of any post-*CALLS* price cap regulatory regime for special access services. As we explain below, as an economic matter, this cannot be

justified, and would have very undesirable consequences. For these reasons, we believe that the Commission should retain its existing X-factor mechanism, which is designed to offset changes in the rate of inflation, and not impose a productivity or growth adjustment – with all the regulatory uncertainty and other problems that this inevitably would entail.

II. SUMMARY OF CONCLUSIONS

3. The Commission should decline to make any productivity adjustment, on either an interim or permanent basis, to its going-forward price cap regulation of special access services. This is so for two fundamental reasons. First, there is no reliable evidence to conclude a fortiori that a productivity adjustment is or will be warranted for the ILECs' special access services. Second, developing an economically correct and relevant productivity factor is a practically insurmountable challenge. The Commission's past efforts to develop a productivity factor were rejected as arbitrary, and the results would be even more arbitrary today. In fact, we conclude that there is no way that the Commission *could* calculate a productivity factor specific to the ILECs' special access business (which is the only type of productivity adjustment that would be in any way defensible). The Commission years ago recognized that the publicly available data made that exceedingly difficult, and recent events, including the Commission's own freeze of ARMIS allocations, would make such an effort even more meaningless.

4. Under these circumstances, imposing a productivity factor in the post-*CALLS* price cap regime would very likely have serious adverse consequences. The goal of any form of price regulation should be to mimic, as closely as possible, pricing in competitive markets. If prices are set too low, the Commission risks discouraging entry and investment by the wireline and intermodal carriers that are actively competing with

incumbent LEC special access. Moreover, the Commission also risks undermining one of the core goals of price cap regulation – encouraging efficiency – by, in effect, punishing carriers that have actually achieved the efficiencies that price cap regulation is supposed to foster. By resurrecting a productivity index in response to ostensibly high returns – particularly when the basis for calculating those returns is so obviously infirm – the Commission would be sending a message that, irrespective of any prior holdings, the Commission is not really committed to pure price caps. That message would dampen efficiency incentives going forward.

5. A productivity factor not only would diminish investment and efficiency incentives; it also is wholly unnecessary. As long as the Commission broadly permits downward pricing flexibility, special access prices will decline as necessary to reflect existing and potential competition, and these price declines will account for any productivity gains that actually are achieved. And where prices do *not* drop in such an environment, that is probably good evidence that they either already are below appropriate levels or that no additional productivity growth is possible. At the very worst, an ILEC's failure to reduce its prices will simply stimulate economically efficient entry (or service expansion) by a competitor.

6. A better approach than an unnecessary and arbitrary productivity factor would be to continue the policy established in the *CALLS Order* and apply an X-factor set equal to the rate of price inflation economy-wide. This approach would provide a check on price cap rates without risking the market-skewing effects of imposing arbitrary productivity calculations.

7. For the same reason, the Commission should not arbitrarily impose a "g" factor, which is an adjustment designed to account for the benefits the ILECs are theoretically enjoying because of increased economies of scale. To begin with, the assumptions and predictions involving any "g" factor would be inherently arbitrary, especially in an era of increasing competition, and setting a "g" factor that artificially depresses rates would have all the negative effects of imposing an overly high productivity factor. And applying *both* a productivity factor and a "g" factor increases this risk, and adds the risk of double counting the same productivity, as the *NPRM* itself recognizes.[1]

8. We also show that it would be particularly arbitrary and ill-advised for the Commission to impose an interim productivity factor, and that the specific adjustment the Commission proposes would be entirely indefensible.

III. BACKGROUND

9. In the wake of its failure to convince the D.C. Circuit that it had a valid basis for the last productivity factor it had adopted,[2] the Commission decided in the *CALLS Order*[3] to eliminate the productivity factor as a means of adjusting price caps for

---

[1] Order and Notice of Proposed Rulemaking, *Special Access Rates for Price Cap Local Exchange Carriers; AT&T Corp. Petition for Rulemaking to Reform Regulation of Incumbent Local Exchange Carrier Rates for Interstate Special Access Services*, 20 FCC Rcd 1994, 2010 ¶ 40 (2005) ("*Notice*").

[2] *United States Tel. Ass'n v. FCC*, 188 F.3d 521 (D.C. Cir. 1999) ("*X-Factor Decision*").

[3] Sixth Report and Order in CC Docket Nos. 96-262 and 94-1, Report and Order in CC Docket No. 99-249, Eleventh Report and Order in CC Docket No. 96-45, *Access Charge Reform; Price Cap Performance Review for Local Exchange Carriers; Low-Volume Long Distance Users; Federal-State Joint Board On Universal Service*, 15 FCC Rcd 12962 (2000) ("*CALLS Order*").

special access and other ILEC services. In its place, the Commission established a separate special access basket of services and adopted a special access "X-factor" that was explicitly *not* designed to reflect changes in productivity. Rather, it was a mechanism designed to reduce special access rates by specific targeted amounts over a five-year period, as a transition to "economically rational competition."[4] At the end of this period, price cap rates effectively would be frozen at 2003 levels unless and until the Commission found that marketplace developments warranted further regulatory changes.[5] Specifically, the special access X-factor was set at 3.0 percent for 2000, and at 6.5 percent in 2001, 2002, and 2003. In the final year of the *CALLS* regime (July 1, 2004 through June 30, 2005), the special access X-factor was set equal to the rate of inflation (measured by the Gross Domestic Product-Price Index).[6] The Commission noted that this mechanism would resolve the ongoing uncertainty over the appropriate level of the X-factor, which it concluded had disrupted business expectations and the future business decisions of ILECs and new entrants alike.[7]

10. The Commission now seeks comment on whether it should reimpose a productivity factor as part of any new price cap regime for ILEC special access services. To answer this question, one must bear in mind the purpose of price cap regulation and the role the X-factor plays in this type of regulatory regime. Like traditional rate-of-return regulation, price caps are intended to emulate the marketplace outcomes and prices

---

4 *Id.* at 12977 ¶ 36.

5 *Id.* at 13025 ¶ 149.

6 *See, e.g., id.*; *Notice* at 2000-01 ¶ 15.

7 *CALLS Order* at 13034 ¶ 174.

that would occur in a competitive environment. Price caps, however, are intended to eliminate the disincentives to efficiency-enhancing investment that result from the ability of regulated firms to pass through their costs to consumers under rate-of-return regulation. Under price cap regulation, a firm's prices for regulated services are capped, and the firm is allowed to retain whatever profits it may earn under those prices. Price cap regulation thus creates strong incentives for firms to increase efficiency in order to increase profits.

11. Under price caps, a firm's prices typically are adjusted each year by inflation, and may include an adjustment to represent the amount by which the regulated firm is expected to experience productivity changes that differ significantly from economy-wide productivity gains or input price changes that differ significantly from inflation in the economy as a whole.[8] (This adjustment is generally referred to as a "productivity factor" or an "X-factor".) Thus, if either (1) input prices required to produce capped services (*i.e.*, prices for the materials, labor, and capital) are expected to increase at a slower rate than input prices for the economy as a whole, or (2) productivity in the production of price cap services is expected to increase more rapidly than productivity for the economy as a whole, then an "X-factor" adjustment would be made to ensure that prices for those services increase more slowly (or decline more rapidly, if inflation is flat or negative) than prices for the economy as a whole.[9] Application of such a factor would be designed to ensure that any unit cost reductions in excess of those

---

[8] *See id.* at 13018 ¶ 135.

[9] By the same token, if either (1) input prices for producing the price cap services are expected to increase at a more rapid rate than input prices for the economy as a whole, or (2) productivity in the production of price cap services is expected to increase more slowly than productivity for the economy as a whole, then prices for price cap services should increase more rapidly than prices for the economy as a whole.

experienced in the economy as a whole are passed through to consumers, to some extent at least, in the form of lower prices.[10]

12. To set a productivity or X-factor, the regulator must first devise a means to calculate the productivity of an industry, firm, or service. In other words, the regulator must determine whether – comparing one period to another – one can either provide a higher quantity of a product (or group of products) or service (or group of services) with the same amount of input resources, or provide the same quantity of a product (or group of products) or service (or group of services) with a smaller amount of input resources. If the answer to one of these questions is affirmative, then the industry, firm, or service has become more productive between the two periods.

13. While the goal is straightforward, calculating changes in productivity is far from an exact science. There is a large body of literature that has emerged as economists have tried to tackle difficult implementation issues, and efforts by regulators and government economists to calculate productivity improvements have been the long-standing subject of disputes and litigation in various regulated industries.[11] The courts,

---

[10] *See, e.g.*, Fourth Report and Order in CC Docket No. 94-1 and Second Report and Order in CC Docket No. 96-262, *Price Cap Performance Review for Local Exchange Carriers; Access Charge Reform*, 12 FCC Rcd 16642, 16647 ¶ 5 (1997) ("*Fourth Price Cap Performance Review Order*").

[11] *See, e.g.*, *Edison Elec. Inst. v. ICC*, 969 F.2d 1221, 1222-1224 (D.C. Cir. 1992) (recounting eight-year process of disputes and litigation leading to the Interstate Commerce Commission's first calculation of productivity changes for the railroad industry); Jerome A. Mark, *Measuring Productivity in Service Industries*, Monthly Labor Review, June 1982, *available at* http://www.bls.gov/opub/mlr/1982/06/art1full.pdf (identifying numerous challenges the Bureau of Labor Statistics was finding it had to address in calculating changes in productivity for the "service industry," which includes trade, finance, insurance, communications, public utilities, government, and business and personal services) ("*Measuring Productivity*").

too, have recognized that measuring productivity is extremely challenging.[12] Disputed issues include the appropriate period over which one should attempt to "normalize" changes in productivity, how "output" should be measured for various activities, and how one "weights" different inputs and outputs in a given productivity calculation. As a practical matter, these issues are complicated by the fact that data maintained in the normal course of business – by individual companies, by various companies as a whole, or across the entire national economy – are rarely maintained with the primary purpose of making productivity calculations.[13] Further, as we explain below, productivity data for a company as a whole may reveal nothing at all about productivity for each of the individual products and services provided by the firm: services that use one mix of labor and materials, or substantial portions of fixed and sunk plant, likely will experience radically different levels of productivity growth and cost reduction than services a

---

[12] *See, e.g., Western Coal Traffic League v. United States*, 677 F.2d 915, 927, 928 (D.C. Cir. 1982) (finding adequate "support in the record" for the Commission's finding that "available productivity measures are . . . unreliable" and noting that "[t]he difficulties of accurately estimating productivity growth are . . . reflected in the diverse results of past studies"); *Rhode Island Consumers' Council v. Smith*, 322 A.2d 17, 22 (R.I. 1974) (holding state PUC properly credited testimony on "the difficulty of measuring with any degree of accuracy the productivity factor," and that the Commission's consequent "refusal to include a productivity offset in the wage and salary item [for electric company's employees] finds support in the evidence.").

[13] As the Bureau of Labor Statistics ("BLS") has observed, "[w]ith regard to labor input measures, the principal problems are data gaps. Information is needed on hours worked by all persons . . . in an individual industry. But although data on hours worked are collected . . . they tend to be limited in scope, or otherwise inconsistent with the output data collected." *See Measuring Productivity* at 4. For example, labor hours tend to be accumulated based on the organization for which an employee works (*i.e.*, reflecting how the employee is managed) and less frequently (and less reliably) in terms of what output services the employee is providing. Thus, for example, we know the location at which a network engineer is assigned, but we do not necessarily know whether he is engineering dedicated special access services, working to resolve trouble reports, or working to develop next year's budget. As a result, trying to develop productivity measures under such circumstances for any given activity or service becomes problematic.

company offers using a different labor/material mix and/or requiring extensive investment in new facilities. Making productivity studies on a company-wide basis is therefore an extremely problematic basis for assessing changes in the productivity of any specific service or product.

14. Beyond questions about the degree to which a regulator can reliably measure *historic* productivity improvements for the relevant service or industry, calculation of an economically relevant productivity factor faces a more fundamental problem. The factor is designed to operate *prospectively*. As explained above, it is designed to capture the degree to which the productivity of the firm or service at issue is *expected* to improve vis-à-vis the economy as a whole. A regulator therefore must establish some basis to predict the degree to which *future* productivity gains will mirror *past* gains. But this is inherently speculative: designing price caps that are to be applied prospectively through a productivity adjustment that is based only on historical data is not particularly logical. In fact, the courts have repeatedly questioned agency efforts to make such predictions.[14] This task has become particularly daunting in the past few

[14] *See, e.g., Shell Oil Co. v. Federal Power Com.*, 520 F.2d 1061, 1078 (5th Cir. 1975) (noting "special problems [faced by] the Commission in using historical figures to predict future productivity"); *USTA v. FCC*, 188 F.3d 521 (D.C.Cir. 1999); *Association of Oil Pipelines v. FERC*, 281 F.3d 239, 247 (D.C. Cir. 2002) (describing efforts to forecast departures from historical trend as being characterized by "complexity and iffiness"). In addition, disputes about the ability to accurately predict future productivity gains were a central focus in UNE arbitrations before the FCC and state commissions. *See, e.g.,* Memorandum Opinion and Order, *Petition of WorldCom, Inc. Pursuant to Section 252(e)(5) of the Communications Act for Preemption of the Jurisdiction of the Virginia State Corporation Commission Regarding Interconnection Disputes with Verizon Virginia Inc., and for Expedited Arbitration*, 18 FCC Rcd 17722, 17776-781 ¶¶ 128-141 (2003) (discussing the parties conflicting positions on productivity gains); Opinion Establishing Revised Unbundled Network Element Rates for Pacific Bell Telephone Company d/b/a SBC California, *Joint Application of AT&T Communications of California, Inc. (U 5002 C) and WorldCom, Inc. for the Commission to Reexamine the*

years in the telecommunications industry, as it faces dramatic competitive, technological, and regulatory transformations.

15. But even during a less dynamic period in the industry, and prior to the Commission's separations freeze (when the available data were not as distorted as they are now), the Commission's efforts to develop a productivity adjustment for price cap services were decidedly unsuccessful, for precisely the reasons set forth above. The Commission has struggled unsuccessfully with efforts to study and predict productivity since adopting price caps.[15] Indeed, the last time the Commission tried to do so, the DC Circuit rejected its efforts as arbitrary. The court specifically questioned the basis upon which the Commission calculated the level of productivity improvement that best captured past gains, and the Commission's assumption that the historical productivity improvements would continue into the future.[16] As we show below, there is no reason to believe the Commission could do a better job now than it has before of determining past or future changes in LEC productivity, or that it could do so for a subset of overall LEC services, and it should not endeavor to do so in this proceeding.

IV. THERE IS NO EVIDENCE THAT A PRODUCTIVITY ADJUSTMENT IS EVEN NECESSARY

16. As an initial matter, a productivity factor is *not* an inherent component of a price cap regime, as the operation of the *CALLS* scheme over the past two years

---

Recurring Costs and Prices of Unbundled Switching in Its First Annual Review of Unbundled Network Element Costs Pursuant to Ordering Paragraph 11 of D.99-11-050, Application 01-02-024, *et al.*, at 65-68 (Cal. P.U.C. Sept. 23, 2004) (discussing differing productivity assumptions and cost model implementation).

[15] *See, e.g., Bell Atlantic Tel. Cos. v. FCC*, 79 F.3d 1195, 1202-1204 (D.C. Cir. 1996) (reciting history of FCC efforts to study productivity).

[16] *X-Factor Decision* at 525-26.

illustrates. Other price cap regimes similarly do not impose an automatic prospective productivity adjustment. For example, the Federal Energy Regulatory Commission developed a price cap regime for regulating oil pipeline rates that adjusts rates for changes in inflation, but not changes in productivity. This price cap regime has been upheld twice by the D.C. Circuit.[17]

17. Indeed, if there is no specific reason to believe that the industry or service will experience productivity gains (or input savings) that are greater than those of the economy overall, there is no reason whatsoever to impose a productivity factor. The courts have deemed regulatory decisions to this effect entirely appropriate.[18] And in fact, imposing a productivity adjustment when there has been no evidence submitted that such productivity or price increase differentials are likely would be counterproductive.

18. This is precisely the prevailing state of affairs for ILECs in the telecommunications industry. As Mr. Toti's declaration demonstrates, overall regulated rates of return for the BOCs in general, and SBC in particular, are *lower* today than they were in 1999. And there certainly is no reason to believe that the ILECs will be more productive in the future than the economy as a whole. Indeed, even if the telecommunications industry as a whole were experiencing higher productivity as compared to rest of economy, this result would reflect the effects of a vast array of providers whose cost inputs are wholly different from the ILECs. Wireless and VoIP

---

[17] *See Association of Oil Pipelines*, 83 F.3d at 1437.

[18] *See id.* at 1437 (upholding failure to apply productivity factor given "no evidence in the record of productivity gains for oil pipelines"); *see also Time Warner Entm't Co. v. FCC*, 56 F.3d 151, 173 (D.C. Cir. 1995) (holding that, in establishing a price cap for cable companies, the FCC reasonably declined to include offsets for productivity gains, for which there was "no . . . evidence . . . in the present record").

providers, for example, no doubt account for huge productivity gains in the industry,[19] but it is unrealistic to assume the ILECs could achieve those same levels of productivity in the near future. In fact, to compete with these leaner providers in the long run, and *ever* achieve those sorts of productivity gains, the ILECs first will have to make major, costly investments, such as the Project Lightspeed initiative that SBC has announced, which will help it meet the stiff competition from cable providers of broadband and VoIP services.[20] In addition, the ILECs continue to provide a substantial number of legacy services over older facilities and plant, have unionized labor forces, and are required to operate in rural and other difficult to serve areas that newer providers typically bypass

---

[19] *See, e.g.*, Jos. A. Rasco, *Engine of Productivity Growth: Productivity*, Oct. 2002 *at* http://www.optimizemag.com/article/showArticle.jhtml?articleID=17700770 ("*Engine of Productivity*").

[20] *See, e.g.*, Press Release, SBC Communications Inc., *SBC Communications To Rapidly Accelerate Fiber Network Deployment In Wake of Positive FCC Broadband Rulings* (Oct. 14, 2004), *at* http://www.sbc.com/gen/press-room?pid=4800&cdvn =news&newsarticleid=21427 (SBC spending between $4 and $6 billion for new broadband network); Jay Sherman, *Telcos Lack Video Numbers*, TELEVISION WEEK, Apr. 25, 2005 (Verizon estimates investment costs of $3 billion for a new fiber network). Without such investments, the ILECs will continue to lose ground to cable competitors. *See* Paul Taylor and Aline Van Duyn, *Cable Groups Make a "Triple Play" for U.S. Households*, FT.COM (Jan. 11, 2005) (quoting Ed Cholerton, head of consumer marketing at SBC as saying "[w]e have to be able to compete with the cable companies. They are moving into our base and we have to move into theirs." Industry analysts believe that "traditional telecommunications operators have little choice but to go head to head with their cable rivals if they are to survive."); Jon Van, *Phone Companies Prepare to Enter Cable TV's Turf*, SAN JOSE MERCURY NEWS at 1F (Oct. 31, 2004) (quoting SBC senior executive vice president, Lea Ann Champion as saying "[t]he riskiest choice of all would be to stay with the status quo. No one is placing a bet on the status quo because that's a sure loser." The competitive threat from cable has forced RBOCs to embrace new technology. Analyst, Jim Hart, senior vice president with the Burwood Group stated that "[i]t comes down to a gold rush where Comcast and the other (cable) companies have started mining the gold. . . . SBC and Verizon realize their traditional services just aren't competitive any more."); Steve Rosenbush, *Verizon's Gutsy Bet*, BUSINESS WEEK at 52 (Aug. 4, 2003) (noting that cable is "cutting into Verizon's cash-cow local-phone business and swiping most of the customers in broadband, the fastest-growing segment of telecom.")

altogether. In short, compelling ILECs to price as if they will necessarily exceed economy-wide productivity – or even achieve the productivity levels of their leaner inter- and intramodal competitors – would be arbitrary and unfair.[21]

19. Furthermore, even if one believed that LEC productivity in particular has improved, or is likely to improve, at a faster rate than productivity economy-wide, there is absolutely no basis for extrapolating from that belief to a conclusion that special access services have performed, or would perform, in a similarly superior manner. Overall LEC productivity is affected by a wide range of business lines, including wireless and other non-legacy businesses that plainly use a different mix of inputs from those used in the special access business. There is no reason to assume that the relative change in prices for those inputs, and the efficiency with which those inputs can be converted into outputs, would be similar across all of the services the LECs provide. Indeed, the Commission itself has recognized that different services may exhibit different levels of productivity,[22] and it explicitly weighted its output analyses in a manner designed to account for

---

[21] It also would send a false economic signal to the market: if these other providers are more efficient, they should be able to enter the market and underprice the ILECs. And that, of course, is a far more rational means of pressuring the ILECs to achieve real world productivity gains than an arbitrary and artificial regulatory price reduction. And intense competition in this industry suggests that any productivity improvements the ILECs *do* experience *will* be passed through to customers in the form of lower prices and/or expanded services as the ILECs try to retain wireline market share.

[22] *Fourth Price Cap Performance Review Order* at 16664-65 ¶ 48 (citing *Railroad Cost Recovery Procedures - Productivity Adjustment*, 5 I.C.C.2d 434, 462 (1989)), aff'd sub nom. *Edison Elec. Inst. v. ICC*, 969 F.2d 1221 (D.C. Cir. 1989)). In the cited decision, the ICC recognized that a TFP calculation could create the appearance of productivity improvements – even when each individual service provided showed no productivity improvement at all – if there were a shift in service mix for the firm from less productive services to more productive services. To avoid this problem, the ICC employed a chained Laspeyres index, which applies the initial period revenue weights for the individual services to *both* the initial and end points in time when computing the productivity improvement for the firm, overall, between the initial to end period.

different levels of productivity in different services in order to avoid distorting the total factor productivity calculation.[23]

20. Obviously, it makes no sense to merely *assume* that productivity improvements experienced by an industry or a group of companies overall would apply to individual services, and to thereby effectively impose productivity "improvements" on prices charged for a line of business that was not actually experiencing that level of improvement. And there are particular reasons to anticipate that ILECs are not experiencing, and will not experience, productivity improvements in at least some aspects of their special access businesses comparable to those likely to be achieved in other parts of the telecommunications business. For example, to the extent that some special access services such as DS1 services are provided over copper facilities – which we understand from Mr. Casto is frequently the case today – the productivity levels for those services are unlikely to ever mirror the types of improvements one would expect for wireless and some fiber-based services.

21. The lack of any evidence that productivity levels for DS1 (and possibly DS3) special access services are higher than those in the economy at large strongly argues against the application of a productivity factor to those services. There is another, entirely separate, reason why such a factor is unnecessary, however. As Mr. Casto and Professor Kalt show in their Declarations, the special access market is highly contestable at all levels, extremely competitive at many levels, and will become increasingly so as

[23] Notably, a weighting technique does not result in a firm-wide or industry-wide total factor productivity calculation that would be properly applicable to an individual service. Instead, it ensures that the overall firm-wide or industry-wide total factor productivity calculation is not distorted by shifts in the mix of individual services, which would continue to exhibit levels of productivity and productivity improvement far different from those developed for the firm or industry as a whole.

new wireline and intermodal competitors (such as cable companies and fixed wireless providers) continue to enter the market. Accordingly, so long as the Commission broadly grants downward pricing flexibility to the ILECs, no regulatory productivity adjustment should be necessary to ensure that prices reflect competitive pressures (and, by extension, actual productivity improvements). Indeed, as Mr. Casto shows, wherever SBC has pricing flexibility, it is responding to market pressures by offering reduced prices and tailored pricing arrangements to meet the competition. These types of pricing adjustments are a far more direct and accurate means of ensuring that prices reflect competitive pressures than an inherently speculative, allegedly predictive productivity factor that would be all the more arbitrary and capricious given the lack of reliable data that can be used as a basis upon which it can be calculated.

22. Furthermore, because the market is at least contestable at all levels, if a LEC *fails* to price its services to reflect real productivity improvements, this will create economically appropriate opportunities for competitive entry (by both intra- and intermodal competitors). As Mr. Casto shows, such entry is now occurring at both the DS3 and DS1 levels.

23. By contrast, resurrecting a productivity factor runs a terrible risk of *slowing* the growth of competition by making it *appear* more attractive for existing and prospective competitors to rely on artificially discounted tariffed services (which would be economically inefficient), and making it more difficult for competitors to compete against those services with their own facilities, even if they are more economically efficient in real terms. To avoid this result, the Commission should simply provide the